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In the Supreme Court of the United States

October Term, 1981

CONTAINER CORPORATION OF AMERICA, *Appellant*,

VS.

FRANCHISE TAX BOARD, *Appellee*.

ON APPEAL FROM THE COURT OF APPEAL OF THE STATE OF CALIFORNIA FOR THE FIRST APPELLATE DISTRICT

BRIEF OF PHILLIPS PETROLEUM COMPANY AS AMICUS CURIAE IN SUPPORT OF APPELLANT

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STATEMENT OF INTEREST

The written consents of Appellant and Appellee are on file with the Clerk of this Court.

Phillips Petroleum Company and its subsidiaries (Phillips) are engaged in petroleum exploration and production and chemical production and sales on a worldwide basis. A substantial portion of Phillips' income is generated in Norway, due to its business activities there.

The effects of the method of state taxation as presented in this case are of vital concern to Phillips, as it is currently contesting the application of this method in several states at the administrative level.

100% of that portion of Phillips' worldwide income that is earned in Norway, as well as most other jurisdictions outside the United States (foreign) is subjected to income tax by those foreign jurisdictions by means of the arm's-length method of determination.

Under the arm's-length method, the income of each business entity is determined, based on generally accepted accounting principles, as if that entity's business was conducted by an independent entity and 100% of that entity's income is subjected to tax by the country in which the entity operates, without reference to income of any affiliated entity.

On the other hand, California and several other states within the U.S., for the purpose of state taxation, use the worldwide combined method of apportioning income. That method requires that Phillips' worldwide income be apportioned to those states by use of a three-factor formula consisting of property, payroll, and sales.

No adjustments (such as deductions or credits for income tax paid to other jurisdictions) are made by California to recognize the effect of the taxing methods employed by the other jurisdictions.

The result of the simultaneous application of these two inconsistent methods to a taxpayer's worldwide income results in multiple taxation of that worldwide income, contrary to the Due Process and Commerce Clauses of the United States Constitution.

Through this Brief, Phillips hopes to alert the Court to the inherent improprieties and inequities in the California method of taxation as applied to taxpayers such as Phillips and their income earned from foreign operations in Norway and other countries where similar conditions prevail.

SUMMARY OF ARGUMENT

As applied by California and other states having similar taxing methods, the worldwide combined method of apportioning income is inherently arbitrary. It grossly distorts the determination of worldwide income, relative to its sources and constitutes oppressive multiple taxation when applied unilaterally by a state taxing jurisdiction, when the arm's-length method is simultaneously applied by foreign jurisdictions.

On the one hand, Phillips is required, by treaty in many instances, such as Norway, to report its income to foreign governments utilizing the arm's-length method of determination of income and, on the other hand, to report its income to a state, such as California, utilizing the worldwide combined method of apportioning income.

Most foreign taxing jurisdictions use the arm's-length method of determining income, which subjects 100% of a taxpayer's income earned in that jurisdiction to its income tax. The use by California and other states of the worldwide combined method of apportionment is inconsistent with the arm's-length method, because the worldwide combined method includes for apportionment income already subjected to tax by one or more other jurisdictions under the arm's-length method. Since the worldwide combined method includes income from foreign jurisdictions which, by virtue of use of the arm's-length method of determining income, will be or have been already taxed, in the foreign jurisdiction, the inevitable result of the use of the worldwide combined method, by California or any other state, is a gross distortion and misallocation of worldwide income. Thus, the worldwide combined method arbitrarily and unreasonably attributes extraterritorial income to California, contrary to the Due

Process Clause of the United States Constitution. This necessarily results in multiple taxation by such states, contrary to the Commerce Clause of the United States Constitution.

In a purely domestic context, this Court can prevent these unconstitutional results when inconsistent income apportionment methods are employed by different states within the United States, because the state taxing authorities are all under its jurisdictional powers. In an international context, however, no tribunal exists which has jurisdictional powers over all of the taxing authorities. Taxpayers under the taxing jurisdiction of both this nation and foreign sovereigns are subjected to and at the mercy of the various and diverse taxing methods around the world.

Avoidance of the unconscionable results of the California worldwide method of apportionment can only be assured by disallowing that method as inherently defective.

ARGUMENT

I

The Worldwide Combined Method of Apportioning Income Is Inherently Arbitrary and Grossly Distorts Worldwide Income and Results in Multiple Taxation of Worldwide Income, in Violation of the Due Process Clause of the United States Constitution

The arm's-length standard for determining income among related domestic and foreign corporations has been adopted by the Internal Revenue Service in administering the Federal tax laws. The regulations implementing Internal Revenue Code § 482 (26 United States Code § 482) evidence this fact:

> (b) *Scope and Purpose.* The purpose of Section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. * * *[1]

True taxable income is defined to mean:

> (6) * * *, in the case of a controlled taxpayer, the taxable income * * * which would have resulted to the controlled taxpayer, had it in the conduct of its affairs * * * dealt with the other member or members of the group at arm's-length * * *.[2]

This method of determination has been accepted on a wide international scale.[3]

The U.S./Norway tax treaty, signed December 3, 1971, and brought into force November 29, 1972, was entered into for the express purpose of "* * * the avoidance of double taxation * * * with respect to taxes on income * * *."[4] This treaty is an effort to guarantee that the income determined taxable by use of the arm's-length method by one jurisdiction is not again subjected to taxation by the other. The treaty provides that business profits of a resident of one country (defined with respect to the United States as including a United States corporation) are taxable in the other country only to the extent

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1. 26 C.F.R. § 1.482 - 1(b).

2. 26 C.F.R. § 1.482 - 1(a)(c).

3. *Tax Treaties with the United Kingdom, the Republic of Korea and the Republic of the Philippines: Hearings before the Senate Comm. on Foreign Relations*, 95th Cong., 1st sess. 33 (1977) (Statement of Laurence N. Woodworth, Assistant Secretary of the Treasury).

4. Income Tax Treaty Between Norway and the United States, CCH Tax Treaties Service ¶¶ 6053, *et seq.*

those profits are attributable to a fixed place of business through which that resident engages in industrial or commercial activities in the other country.[5] One hundred percent of the income thus determined to be attributable to a fixed place of business in either country is subjected to taxation by that country,[6] and relief from double income taxation (as between Norwegian taxes and taxes imposed by the federal government of the United States) is afforded by the treaty, by provisions for tax credits by the U.S. to U.S. residents and tax credits and exemptions by Norway to residents of Norway.[7]

In addition, by statute, to avoid double taxation by the United States of the income of taxpayers under its jurisdictional power, the United States allows foreign tax credits or deductions to offset its inclusion of foreign source income in the U.S. base.[8] There is no comparable relief afforded by California at the state level.

The California worldwide combined method of state taxation ignores this treaty based arm's-length method of determining income, under which 100% of Phillips' income earned in Norway has been subjected to Norwegian tax, and instead requires a formulary apportionment of all worldwide income, including that allocated by treaty to Norway. The inevitable result of this inherently arbitrary requirement coupled with the dictates of the U.S./Norway tax treaty is a gross multiple taxation of foreign earned income. The California method necessarily results in arbitrarily and unreasonably attributing to California income earned and already fully subjected to tax in a foreign country like Norway.

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5. Ibid, footnote 4, ¶¶ 6056, 6057 and 6075.
6. Ibid., footnote 4, ¶ 6077.
7. Ibid., footnote 4, ¶ 6076.
8. 26 U.S.C. § 901.

To illustrate such effects, Phillips has computed the income that would be attributable to Norway using the California three-factor apportionment formula. This formulary apportionment results in attributing income, in millions of dollars, to Norway for 1979 and 1980 of $198.8 and $433.9, respectively. The taxes which were actually paid on income earned using the arm's-length method of determination were, in millions of dollars, $645.1 and $1,467.4 or 324% and 338% of the income apportionable to Norway under the California basis of formulary apportionment.

As is shown by the fact that taxes paid by Phillips to Norway on income earned there are more than triple the total amount of income that California's method of apportionment would allocate to Norway, it is obvious that Phillips' total income earned in Norway had to have actually been, and was, substantially in excess of the amount indicated by California's method of apportionment. In the case of a California taxpayer, like Phillips, which also conducts business in foreign jurisdictions, California's method of apportionment, if it is to comply with the mandates of the Due Process and Interstate and Foreign Commerce Clauses, must allocate to California only that portion of the taxpayer's worldwide income which fairly represents the taxpayer's actual income from California business. California apparently recognizes these mandates and seeks compliance with them by application to the taxpayer's total worldwide income of a fraction, in which payroll, property and sales in California constitute the numerator, and those items worldwide constitute the denominator. If this fraction is applied to total worldwide income, it indisputably attributes an unreasonably and unrealistically *low* portion of Phillips' worldwide income to Norway, as shown by the 324% and 338% of tax thereon paid to Norway. It is axiomatic that this method must necessarily attribute an unreasonably and unrealistically

high portion of the remainder of Phillips' worldwide income to California and/or other jurisdictions. This illustration shows that California's method of apportionment arbitrarily leads to grossly distorted results, and is obviously and grossly defective in general and as applied to Phillips. When such a formula leads to a grossly distorted result, the Due Process Clause of the United States Constitution is violated. *Norfolk & Western Railway Co. v. Missouri State Tax Commission*, 390 U.S. 317, 326 (1968).

Even though a tax of over 300% of income determined under California's method of apportionment has been paid to the country in which the income was earned, California's method would subject this income to an additional duplicative tax, by including it, and income from other foreign jurisdictions, in Phillips' total income for purposes of California's formula. Under this California computation, a negative Norway income would result after Norway taxes are deducted, but no credit or deduction is allowed under California law for these foreign taxes paid. The effect therefore becomes a California tax on the taxes paid to another jurisdiction such as Norway.

Inasmuch as most countries utilize the arm's-length method of determining taxable income, California's use of the worldwide combined method of determining taxable income inevitably leads to a certain unavoidable degree of multiple taxation. Such a taxing method cannot be allowed, by this Court, to persist.

II

The Worldwide Combined Method of Apportioning Income Is Unconstitutional Under the Commerce Clause of the United States Constitution

This Court stated in *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979) that two additional require-

ments over and above those applicable under the Interstate Commerce Clause must be met when testing a tax on instrumentalities of foreign commerce under the Foreign Commerce Clause. "First, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments'." *Japan Line*, 441 U.S. at 451. These requirements must be applied to California's worldwide combined method of apportioning income.

As demonstrated above, the worldwide combined method of apportioning income as is done by California, in conjunction with a foreign country's determination of income by the arm's-length method, inevitably results in international multiple taxation and the imposition of tax on more than "one full value".

"Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though 'fairly apportioned' to reflect an instrumentality's presence within the state, may subject foreign commerce 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids'." *Japan Line*, 441 U.S. at 447-48 citing *Evco v. Jones*, 409 U.S. 91 (1972), at 94, quoting *J. D. Adams Mfg. Co. v. Storen*, 304 U.S. 307 (1938), at 311. That principle, announced by this Court in the course of its consideration of California's taxation of items of personal property, is equally applicable to California's taxation of a taxpayer's income. The burden on foreign commerce is not less onerous or intolerable because of the object of the tax in question here.

Norway and the United States have entered into a treaty whereby income is determined utilizing the arm's-length method.[9] Norway has the right to tax income within its jurisdiction as determined under that treaty. Norway is not required to make any correlative adjustment to accommodate the perceived taxing right of California on that income.

The second additional principle enunciated in *Japan Line* is that a tax cannot prevent the federal government from "speaking with one voice when regulating commercial relations with foreign governments."[10] Through the treaty process the U.S. Government has spoken for all the states. Norway has one tax treaty with all of the United States, not fifty individual treaties.[11] Income taxable by the United States and Norway is determined under the treaty by use of the arm's-length method. California's laws and similar laws of other states cannot be permitted to ignore the treaty process in violation of the mandates of the United States Constitution and this Court. "Where those laws conflict with a treaty, they must bow to the superior federal policy." *Zschernig v. Miller*, 389 U.S. 429, at 440 (1968).

Because the California worldwide combined method of apportioning income inherently conflicts with the arm's-length method embodied in the Income Tax Treaty between Norway and the United States results in multiple taxation, the California worldwide combined method of apportioning income violates the precepts which must be satisfied when considering foreign commerce questions, as enunciated in *Japan Line*, hence, is unconstitutional under the Commerce Clause. *Japan Line*, 441 U.S. 434, at 448.

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9. **Footnote 4.**

10. ***Japan Line*, 441 U.S. 434, at 451.**

11. **Footnote 4.**

CONCLUSION

When applied in conjunction with the arm's-length method of apportioning income, the unilateral application by a state of the worldwide combined method of apportioning income, as in the case of California, results in unconscionable multiple international taxation. There is no tribunal other than this Court that exists to safeguard U.S. taxpayers against this result. Consequently, the Court should act to prevent the duplicative tax results by invalidating the use of combined formulary apportionment, as applied by states such as California, to income that has all been taxed by a foreign sovereign.

Respectfully submitted,

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